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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1942

No. 560

CHARLES T. KLINE,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT AND BRIEF IN SUPPORT THEREOF.

J. WARREN BROCK,
Counsel for Petitioner.

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CHARLES T. KLINE,

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COMMISSIONER OF INTERNAL REVENUE.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

The petitioner, Charles T. Kline, respectfully prays that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Third Circuit, entered in the cause between the above-named parties, on September 1, 1942, which judgment affirmed a decision of the United States Board of Tax Appeals.

Judgments Below.

The judgment of the Circuit Court of Appeals, a review of which is sought herein, was entered on September 1, 1942, and is set forth in the Record at page 209.

The decision of the Board of Tax Appeals, which was affirmed by the aforesaid judgment of the Circuit Court of Appeals, was entered on September 25, 1941, and is set forth in the Record at pages 193(a)-200(a).

Questions Presented.

1. In determining the Federal gift tax on petitioner's gift of corporate stock, which involved a determination of the taxable value of said stock, did the Circuit Court give proper effect, if any, to the fact that the stock was subject to a restrictive agreement giving the corporation an option to repurchase the stock at 33⅓ per cent, 50 per cent, or 75 per cent, of its book value, the applicable percentage depending upon the manner of the termination of the petitioner-donor's employment by the corporation?

2. Did not the Circuit Court ignore the uncontradicted and unimpeached testimony of the petitioner's expert witnesses as to the value of the aforesaid stock, and if so, did not its action in so doing constitute reversible error?

3. Is not the valuation of the aforesaid stock approved by the Circuit Court, arbitrary and capricious in that said valuation is not supported by substantial evidence?

Statutes and Regulations Involved.

The statutes and regulations involved are set forth in the Appendix hereto, at page 22.

Statement.

This was a petition to the United States Board of Tax Appeals, wherein the petitioner prayed for a redetermination of his Federal gift tax for the calendar year 1937. The Board sustained the respondent's determination of the said tax, and on appeal, the Circuit Court of Appeals

affirmed the decision of the Board. The essential facts are as follows:

On December 24, 1937, Charles T. Kline, the petitioner in this proceeding, was the owner of a voting trust certificate, evidencing the petitioner's equitable, or beneficial, ownership of 4,500 shares of the common stock, without nominal or par value, of E. J. Lavino and Company, a Delaware corporation. (Stipulation of Facts, [hereinafter called the "Stipulation"], par. 22, R. 32a-35a; Stipulation, par. 32a, R. 40a.) On that date, the shares of stock, represented by the said voting trust certificate, were subject to the terms and provisions of a so-called "restrictive agreement" between the petitioner and E. J. Lavino and Company, dated October 22, 1929. (Stipulation, par. 13-16, R. 24a-27a; the restrictive agreement, R. 15a-18a.)

In the restrictive agreement, it was provided that the petitioner should not sell any of the Company's common stock so long as he remained in the Company's employment, without the consent of the Company. The agreement further provided that during the period of one year after the termination of the petitioner's employment by the Company, the Company should have an option to purchase the petitioner's stock at, (a), 33 1/3 per cent, (b), 50 per cent, or (c), 75 per cent, of its book value as shown on the Company's statement as of the date of the last closing of its books prior to such termination, the applicable per centage was due, (a), to his discharge by the Company for cause, (b), to his resignation *without* the approval of the Company's board of directors, or, (c), to his death, or his resignation *with* the approval of the board of directors.

On December 1, 1937, a regular meeting of the board of directors of E. J. Lavino and Company was held, at which time the said board adopted the following resolution:

> "RESOLVED that there would be no objection on the part of the Corporation to the transfer of common

stock registered in the name of Charles T. Kline, subject to restriction agreement, to Charles T. Kline, Trustee, for the benefit of Ellen S. Kline, *the said stock after transfer to still be subject to the restriction agreement heretofore obtaining*" (Emphasis supplied).

(Stipulation, par. 31, R. 40a; Exhibit 16A, R. 69a-71a.)

On December 24, 1937, the petitioner caused his voting trust certificates, representing his 4,500 shares of the common stock of E. J. Lavino and Company, to be transferred to, and a new certificate to be issued in the name of, "Charles T. Kline, Trustee Under Deed of Trust, Dated December 24, 1937" (Stipulation, par. 32, R. 40a). On the same date, the petitioner executed and delivered an irrevocable deed of trust in which it was recited that the petitioner had caused his voting trust certificate, for 4,500 shares of the common stock of E. J. Lavino and Company, to be transferred into his name as trustee, and the petitioner acknowledged and declared that he held the shares of stock evidenced by the said voting trust certificate, *in trust,* to pay the net income to his wife, Ellen S. Kline, for life, and thereafter, to pay the net income to the petitioner's son, Charles T. Kline, Jr., until he should attain the age of 40 years, and at that time, to pay over and deliver, to his said son, the principal of the trust estate. The deed of trust further provided that if the son died before receiving the principal of the trust estate, the principal was ultimately to be paid to the son's issue, if any, or to the petitioner's wife, or to her appointees by will. The deed expressly declared that the trust therein created was to be irrevocable; the petitioner did not retain, or have any beneficial interest in the trust; and there was no possibility of the trust ever reverting to the petitioner (Stipulation, par. 33, R. 40a-41a; the Deed of Trust, R. 12a-15a).

The date of the last closing of the books of E. J. Lavino and Company, prior to December 24, 1937, was December

31, 1936 (R. 150a-151a), and the book value of the common, no par value stock of the said Company, as shown on its balance shee[1] as of December 31, 1936, was $36.03 (Exhibit 20-A, fourth statement, R. 79a-80a).

In his gift tax return for 1937, the petitioner reported the gift of the 4,500 shares of stock here involved at $57,-073.50, which was intended to represent 33 1/3 per cent of its book value *at December 31, 1936.* This computation was erroneous, the correct book value of the stock at December 31, 1936, being $36.03 per share, or $162,135 for the 4,500 shares, and 33 1/3 of that amount being $54,045. On his return for 1937, the petitioner paid a gift tax in the amount of $243.31.

The respondent increased the taxable value of the stock to $43. per share, this valuation of the stock being explained in the respondent's brief submitted to the Board of Tax Appeals, as follows:

"Common stock, 50,000 shares outstanding $ 500,000.00
Surplus—December 31, 1937 (Ex. 20A) 1,753,779.89

50,000 shares common stock x $45.075 per share (book value) equals	$2,253,779.89
[1] 75% of $45.075 (book value) 12/31/37 per share equals	33.80
Add 75% of three year purchase of excess earnings available on common stock after payment of dividends on these shares	9.48
Total value per share	$43.28

"After taking into consideration all factors involved, the Commisioner determined that the fair market value for gift tax purposes of each share of 'restricted' com-

[1] This refers to footnote in respondent's brief submitted to Board of Tax Appeals not reprinted here.

mon stock of E. J. Lavino & Company owned by the petitioner on December 24, 1937, was $43.00 per share."[2]

At the hearing before the Board, the petitioner called and qualified two expert witnesses to testify as to the value of the common stock of E. J. Lavino and Company on December 24, 1937, if not subject to the provisions of the restrictive agreement, and when subject to its provisions. The first witness testified that the said common stock, if not subject to the restrictive agreement, had a fair market value of $30.90 per share (R. 167a).

The second witness testified that the said common stock, if not subject to the restrictive agreement, had a fair market value within " * * * a low limit of somewheres around 25 and a high limit of somewheres between 35 and 40; but, roughly, I would say that $30. a share was a fair price, all things considered" (R. 177a). However, this same witness also testified, in effect, that when subject to the restrictive agreement, the fair market value of the stock was not in excess of the prices at which the Company could repurchase the stock (R. 178a), and, under questioning by the Board Member, the witness further testified, in effect, that when subject to the restrictive agreement, the stock had no fair market value whatsoever (R. 179a-180a).

The respondent-Commissioner of Internal Revenue offered no evidence as to the value of the common stock of E. J. Lavino and Company, either when subject, or not subject, to the provisions of the restrictive agreement.

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[2] It will be noted that this determination employs 75 per cent. of book value as of December 31, 1937, to which is added "75% of three year purchase.....9.48." It is submitted that neither of these procedures is authorized by the restrictive agreement or otherwise, and hence, that the determination is arbitrary and capricious.

Rulings of the Courts Below.

The Board sustained the respondent's determination of the petitioner's gift tax for 1937, and, on September 25, 1941, the Board entered its decision determining a deficiency in the petitioner's gift tax, for the said year 1937, in the amount of $13,140.44 (R. 200(a)). In its findings of fact and opinion (R. 193a-199a), the Board utterly ignored the testimony of the petitioner's expert witnesses as to the fair market value of the stock when subject, and when not subject, to the restrictive agreement; it indicated that, in the instant case, the restrictive agreement probably had no effect on the fair market value of the stock; and then, inconsistently, approved the respondent's determination of the value of the stock, in which, it is submitted, the respondent had given a purely arbitrary and capricious effect to the restrictive agreement.

The Circuit Court affirmed the Board's decision (R. 209). In its opinion (R. 203-308), the Court referred to the testimony of the petitioner's expert witnesses, but gave no effect to it. The Court also referred to the restrictive agreement, but, apparently, gave it no effect because it regarded the earning power of the stock as having greater significance. The Court then concluded its opinion by affirming the Board's decision, thus approving the respondent's determination of the value of the stock, which, as is submitted, was arbitrary and capricious.

Reasons for Granting the Writ.

1. The decision of the Circuit Court in the instant case is probably in conflict with the decision of this Court in *Helvering* v. *Tex-Penn Oil Co.*, 300 U. S. 481, or with the decision of this Court in *Helvering* v. *Salvage*, 297 U. S. 109.

2. The decision of the Circuit Court in the instant case is in conflict with decisions of other Circuit Courts and the

Board of Tax Appeals, (a), following *Helvering* v. *Tex-Penn Oil Co.*, 300 U. S. 481, or, (b), with such decisions following *Helvering* v. *Salvage*, 297 U. S. 109.

3. The decision of the Circuit Court in the instant case is in conflict, *inter alia*, (a), with the decisions of the Circuit Courts of Appeals for the Second, Eighth and Ninth Circuits in *Bonwit Teller & Co.* v. *Commissioner*, 2 Cir., 53 F. (2d) 381, *Planter's Operating Co.* v. *Commissioner*, 8 Cir., 55 F. (2d) 583, and *Belridge Oil Co.* v. *Commissioner*, 9 Cir., 85 F. (2d) 762, and (b), with its own decisions in *Tex-Penn Oil Co.* v. *Commissioner*, 3 Cir., 83 F. (2d) 518 (affirmed, 300 U. S. 481), *Boggs & Buhl, Inc.* v. *Commissioner*, 3 Cir., 34 F. (2d) 859, *Pittsburgh Hotel Co.* v. *Commissioner*, 3 Cir., 43 F. (2d) 345, and *Nichols* v. *Commissioner*, 3 Cir., 44 F. (2d) 157.

4. The law with respect to the valuation of corporate stock, subject to restrictive or option agreements, for tax purposes, is in a state of confusion, which will probably result in considerable litigation unless and until the law is clarified by this Court.

5. The decision of the Circuit Court in the instant case is arbitrary and capricious, in that it is not supported by substantial evidence.

WHEREFORE, it is respectfully submitted that this petition for a writ of certiorari should be granted.

J. WARREN BROCK,
Counsel for Petitioner.

Dated: December 1, 1942.

BRIEF IN SUPPORT OF FOREGOING PETITION FOR WRIT OF CERTIORARI.

Opinions of the Court Below.

The opinion of the Circuit Court of Appeals is reported at 130 F. (2d) 942, and is set forth in the Record at pages 203-208.

The findings of fact and opinion of the Board of Tax Appeals is reported at 42 B.T.A. 1052, and is set forth in the Record at pages 193a-199a.

Jurisdiction.

The judgment of the Circuit Court of Appeals was entered on September 1, 1942 (R. 209).

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925, c. 229 (43 Stat. 938; 28 U. S. C. A. Sec. 347).

Statement of Facts—Questions Involved.

The petition for the writ of certiorari contains a statement of the case and the questions involved, and also, a statement of all the facts material to their consideration.

Specifications of Errors.

1. In determining the Federal gift tax on petitioner's gift of corporate stock, which involved a determination of the taxable value of the stock, the Circuit Court erred in failing to give proper effect, if any, to the fact that the stock was subject to a restrictive agreement giving the corporation the right to repurchase the stock at varying per centages of its book value as aforesaid.

2. The Circuit Court erred in that it ignored the uncontradicted and unimpeached testimony of the petitioner's expert witnesses as to the value of said stock.

3. The Circuit Court erred in that its determination of the value of said stock is arbitrary and capricious, not being supported by substantial evidence.

4. The Circuit Court erred in entering judgment affirming the decision of the Board of Tax Appeals.

Argument.

1. The decision of the Circuit Court in the instant case is probably in conflict with the decision of this Court in *Helvering* v. *Tex-Penn Oil Co.*, 300 U. S. 481, or with the decision of this Court in *Helvering* v. *Salvage*, 297 U. S. 109.

As has been noted, the subject of the gift involved in this proceeding was a voting trust certificate evidencing the petitioner's equitable or beneficial ownership of 4,500 shares of the common stock of E. J. Lavino and Company, *subject to the terms and provisions of the restrictive agreement.* It has also been noted that the restrictive agreement provided that the petitioner could not sell his stock so long as he remained in the employment of the Company. The agreement further provided that during the period of one year after the termination of the petitioner's employment, the Company had an option to purchase his stock at (a), 33⅓ per cent, (b), 50 per cent, or (c), 75 per cent, of its book value as shown on the Company's statement as of the date of the last closing of its books prior to such termination, the applicable percentage depending upon whether the termination of the petitioner's employment was due, (a), to his discharge by the Company, for cause, (b), his resignation *without* the approval of the Company's board

of directors, or, (c), his death, or resignation *with* the approval of the board of directors.

Considering these provisions of the restrictive agreement, how could an employee-owner of the stock and a prospective purchaser, assuming both to have been "reasonable men", have arrived at the "fair market value" of the stock on December 24, 1937? Since the date of the termination of the employment of the employee-owner of the stock could not have been ascertained, it would obviously have been impossible to determine the book value of the stock as of the date of the last closing of the books of the Company prior to such termination. Moreover, it would have been impossible to foresee the cause, or reason, for the termination of the employment of the employee, i. e. whether such termination would be caused by the employee's discharge, his resignation, with or without the approval of the Company's board of directors, or by his death. Thus, neither the base, nor the percentage to be applied thereto, in determining the amount which the Company would have to pay, if, at some indefinite time in the future, it elected to exercise its option to purchase the employee's stock after the termination of his employment, were known, nor could they have been ascertained, on December 24, 1937.

In other words, on December 24, 1937, neither the employee-owner of common stock of E. J. Lavino and Company, subject to the restrictive agreement, nor a prospective purchaser of the stock, would have known when, if ever, the purchaser (if he purchased the stock), would become the absolute owner thereof. They would not have known when, if ever, the Company would elect to purchase the stock, nor the price it would have to pay if it did elect to purchase the stock. They would have known, however, that if the Company did elect to purchase the stock, at some indefinite time in the future, the price it would have to pay

might be as low as one-third, or as high as three-fourths, of its book value as of the date of the last closing of its books prior to the termination of the employee's employment, and also, they would have known that there was, of course, a possibility that the Company might encounter financial difficulties, or suffer reverses, as the result of which its stock might become absolutely worthless.

The manifest uncertainties inherent in this situation could be developed indefinitely. For example, under ordinary circumstances, an investor in the common stock of a corporation is faced with the uncertainty as to the future earnings of the corporation, and what part of such earnings will be declared as dividends; but he at least knows that he will receive 100 per cent of any appreciation in the value of his stock. In the situation now under consideration, a prospective purchaser of the common stock of E. J. Lavino and Company would have been faced with the usual uncertainties, but in addition, he would have known that he would probably only share in any increase in the value of his stock *to the extent that such increase was reflected in the books of the Company, and he would not have known whether he could ultimately receive 33⅓, 50, or 75 per cent of any increase in value so reflected.*

Accordingly, since the evaluation of the stock here involved as of December 24, 1937, involved so many unknown and unascertainable factors, it is respectfully submitted that either (a) the said stock had no fair market value capable of being ascertained with reasonable certainty; or, (b), the fair market value of the said stock was not in excess of the minimum amount at which E. J. Lavino and Company might have become entitled to repurchase the stock. In other words, it is submitted that the instant case is governed either by the decision of this Court in *Helvering* v. *Tex-Penn Oil Co.*, 300 U. S. 481, or by the decision of this Court in *Helvering* v. *Salvage*, 297 U. S. 109.

Helvering v. *Tex-Penn Oil Co., supra,* involved the evaluation of the stock of a new corporation which had been organized to acquire and develop certain oil properties. A part of its stock had been distributed pursuant to an agreement which prevented the recipients from selling the stock for a period of ninety days, and a bankers' syndicate, which had agreed to purchase another block of the stock, had the right to extend the said period for an additional ninety days. In holding that the stock had no fair market value when distributed to the recipients, this Court said (300 U. S. 481 at 499):

> "The court is also of opinion that the judgments must be affirmed upon the ground that in the peculiar circumstances of this case, the shares of Transcontinental stock, regard being had to their highly speculative quality and to the terms of a restrictive agreement making a sale thereof impossible, did not have a fair market value, capable of being ascertained with reasonable certainty, when they were acquired by the taxpayers.
>
> "In the absence of such value, the ownership of the shares did not lay the basis for the computation of a gain at the time they were received, or for a tax as of that date under the applicable statute."

Even though the stock here involved may not have had a "highly speculative quality", it is submitted that here, the restrictive agreement itself deprived the stock of "fair market value, capable of being ascertained with reasonable certainty".

In any event, it is submitted that the stock here involved could not have had a fair market value in excess of the minimum amount at which E. J. Lavino and Company might have become entitled to repurchase the stock. In *Helvering* v. *Salvage,* 297 U. S. 106, *supra,* it appeared that in December, 1922, the taxpayer acquired 1,500 shares of the stock of the Viscose Company for which he paid the said Com-

pany $100 per share, and he also entered into an agreement, with the said Company, that he would not engage in business competition with the Company. The taxpayer further agreed that during 1923, the Company could repurchase five-sevenths of the stock at par, during 1924, four-sevenths, etc. Intrinsically, when unencumbered, the stock was worth $1,164.70. Subsequently, the question arose as to what was the taxpayer's cost basis for the said shares of stock, in determining his gain on a disposition of the stock, or a part thereof, in 1929, and in holding that the cost basis of five-sevenths of the shares was their par value, or $100 per share, the Circuit Court of Appeals, for the Second Circuit, said (76 Fed. (2d) 114):

> "As to two-sevenths of the 1,500 shares, the petitioner acquired their full value on December 30, 1922. As to the rest, the Viscose Company still had a string upon them by virtue of its option. Until the option expired in subsequent years, the market value of the shares subject to it could scarcely exceed the price at which the company could repurchase them, namely, par. See Wilson v. Bowers, 57 F. (2d) 682, 683 (C. C. A. 2) * * * Two-sevenths of the shares (428 4/7) were not subject to the option and had a market value of $1,164.70 a share, a total of $499,157.14; five-sevenths (1,071 3/7) had a market value of $100 per share, or $107,142.86. This gives a total market value for the 1,500 shares of $606,300."

In affirming this decision, this Court said (297 U. S. 109):

> "Considering the option to repurchase at par, outstanding in 1922, there could be no proper finding of fair market value at that time in excess of $100 per share. In the circumstances, the court did not err in so holding."

In the instant case, if the petitioner had been discharged from his employment by E. J. Lavino and Company on or before December 31, 1937, the Company would have had the

right, at any time within one year from the date of such discharge, to purchase the petitioner's stock at 33⅓ per cent. of its book value as of December 31, 1936, or, in other words, at 33⅓ per cent. of $36.03, or $12.01 per share. In these circumstances, it is submitted that the decision of this Court in *Helvering* v. *Salvage, supra,* is ample authority for the proposition that the fair market value of the stock here involved at December 24, 1937, was not in excess of the said sum of $12.01 per share.

As has been noted, the Circuit Court in the instant case determined that on December 24, 1937, the stock here involved had a fair market value of $43 per share. Hence, it is obvious that the said Court actually gave no force or effect whatsoever to the restrictive or option agreement, and it is therefore submitted that its decision is in conflict either with the decision of this Court in *Helvering* v. *Tex-Penn Co., supra,* or with the decision of this Court in *Helvering* v. *Salvage, supra.*

2. The decision of the Circuit Court in the instant case is in conflict with decisions of other Circuit Courts and the Board of Tax Appeals, (a), following *Helvering* v. *Tex-Penn Oil Co.,* 300 U. S. 481, or, (b), with such decisions following *Helvering* v. *Salvage,* 297 U. S. 109.

The decision of this Court in *Helvering* v. *Tex-Penn Oil Co.,* 300 U. S. 481, was followed by the Circuit Court of Appeals for the Second Circuit in *Propper et al.* v. *Commissioner,* 89 F. (2d) 617, and by the Board of Tax Appeals in *Kopple* v. *Commissioner,* 35 B. T. A. 1056, in both of which decisions it was *held* that the stock of the corporations there involved had no fair market value, *inter alia,* because in each case, the stock was subject to an agreement which restricted the sale thereof. Hence, if the decision in the instant case is governed by the decision of this court in *Helvering* v. *Tex-Penn Oil Co., supra,* then, it is submitted, the decision in the instant case is in conflict with the aforesaid

decisions in *Propper et al.* v. *Commissioner* and *Kopple* v. *Commissioner,* both *supra.*

On the other hand, if the decision in the instant case is governed by the decision of this Court in *Helvering* v. *Salvage,* 297 U. S. 106, then, it is submitted, the decision in the instant case is in conflict with the decision of the Circuit Court of Appeals for the Second Circuit in *Lomb* v. *Sugden,* 82 F. (2d) 166, and with the decision of the Board of Tax Appeals in *Bensel* v. *Commissioner,* 36 B. T. A. 246 (affirmed, 3 Cir., 100 F. (2d) 639), in both of which cases it was *held,* following *Helvering* v. *Salvage, supra,* that the value of shares of stock of a corporation, subject to an option agreement, was not in excess of the price fixed in the agreement.

3. The decision of the Circuit Court in the instant case is in conflict, *inter alia,* (a), with the decisions of the Circuit Courts of Appeals for the Second, Eighth and Ninth Circuits in *Bonwit Teller & Co.* v. *Commissioner,* 2 Cir., 53 F. (2d) 381, *Planter's Operating Co.* v. *Commissioner,* 8 Cir., 55 F. (2d) 583, and *Belridge Oil Co.* v. *Commissioner,* 9 Cir., 85 F. (2d) 762, and (b), with its own decisions in *Tex-Penn Oil Co.* v. *Commissioner,* 3 Cir., 83 F. (2d) 518 (affirmed, 300 U. S. 481), *Boggs & Buhl, Inc.* v. *Commissioner,* 3 Cir., 34 F. (2d) 859, *Pittsburgh Hotel Co.* v. *Commissioner,* 3 Cir., 43 F. (2d) 345, and *Nichols* v. *Commissioner,* 3 Cir., 44 F. (2d) 157.

As has been noted, at the hearing before the Board in the instant case, one of the petitioner's expert witnesses testified that the stock here involved, if *not* subject to the restrictive agreement, had a fair market value of $30.90 per share (R. 167a). The petitioner's second expert witness testified that the stock, if *not* subject to the restrictive agreement, had a fair market value within "* * * a low limit of somewheres around 25 and a high limit of somewheres between 35 and 40; but, roughly, I would say that

$30 a share was a fair price, all things considered" (R. 177a). This second witness further testified, in effect, that when subject to the restrictive agreement, the stock had no fair market value whatever (R. 179a, 180a), but that in any event, when so subject, the fair market value of the stock was not in excess of the minimum price at which the Company might repurchase the stock (R. 178a).

Since the Board and Circuit Court determined that the value of the said stock, when subject to the restrictive agreement, was $43 per share, it is evident that both the Board and the Court completely ignored and disregarded the testimony of the petitioner's expert witness, although the said testimony was uncontradicted and unimpeached. It is submitted that this constituted reversible error, and that as a result, the decision of the Circuit Court is in conflict with the following decisions of the Circuit Courts of Appeal for the Second, Eighth and Ninth Circuits:

Bonwit Teller & Co. v. *Commissioner,* 2 Cir., 53 F. (2d) 381;

Planter's Operating Co. v. *Commissioner,* 8 Cir., 55 F. (2d) 583;

Belridge Oil Co. v. *Commissioner,* 9 Cir., 85 F. (2d) 762.

Each of the foregoing decisions is authority for the proposition that it is reversible error for the Board to disregard competent, relevant testimony when it is not contradicted; and, as a matter of fact, the decisions of the Circuit Court of Appeals for the Third Circuit are to the same effect. See *Boggs & Buhl, Inc.* v. *Commissioner of Internal Revenue,* 3 Cir., 34 F. (2d) 859; *Pittsburgh Hotels Co.* v. *Commissioner of Internal Revenue,* 3 Cir., 43 F. (2d) 345; and *Nichols* v. *Commissioner of Internal Revenue,* 3 Cir., 44 F. (2d) 157.

It is submitted that the foregoing decisions are especially applicable in the instant case. It is true that in the instant

case, there was some evidence, principally the earnings and dividend record of the Company, upon which the Circuit Court could base its independent determination of the value of the stock here involved, *if not subject to the restrictive agreement.* However, there is nothing in the present Record to indicate that either the Board or the Circuit Court of Appeals possessed any special competency which would justify either the Board or the Court in substituting their judgment as to the effect of the restrictive agreement upon the fair market value of the stock here involved, for the judgment of the petitioner's expert witness.

4. The law with respect to the valuation of corporate stock, subject to restrictive or option agreements, for tax purposes, is in a state of confusion, which will probably result in considerable litigation unless and until the law is clarified by this Court.

It is submitted that this statement cannot be denied. In *Helvering* v. *Tex-Penn Oil Co.* 300 U. S. 481, in *Helvering* v. *Salvage,* 297 U. S. 106, and in the other decisions of the Board of Tax Appeals, and of the Circuit Courts of Appeals to which reference has been made, in determining the value of corporate stock subject to restrictive or option agreements, due effect has been given to such agreements either as depriving the stock of fair market value, or as limiting such value to the amounts fixed in the agreements.

On the other hand, in the instant case, it would seem to be clear that in determining the value of the stock here involved to be $43 per share, the Circuit Court has given no force or effect whatsoever to the restrictive agreement to which this stock was subject. As has been noted, a prospective purchaser of the petitioner's stock on December 24, 1937, would have known that if the petitioner was discharged from his employment for cause on or before December 31, 1937, the Company would have the right, at any time within one year thereafter, to purchase the stock at

$12.01 per share. It may be, as the Circuit Court said, that this result was not likely to happen, but even so, it was a possibility which a prospective purchaser of the stock would have taken into consideration, and which, it is earnestly urged, would have influenced such a purchaser to refuse to pay more than the said sum of $12.01 per share for the stock, as the petitioner's expert witness testified.

It is submitted, therefore, that in determining the value of the stock here involved to be $43 per share, the Ciircuit Court has abandoned the test of "fair market value", as prescribed in the applicable Regulations, (see Appendix hereto, page 22), and has, in effect, adopted some new test which is not explained. It is further submitted that this uncertainty and confusion in the law with respect to situations of this kind, will probably result in considerable litigation unless and until the law is clarified by this Court. As some evidence of the probable truth of this assertion, since the decision of the Circuit Court in the instant case was handed down, counsel for the petitioner has been advised, on September 17, 1942, by James Henry Hayes, Esq., 30 Rockefeller Plaza, New York, N. Y., that he had a case similar to the instant case which would soon come to trial, forum not stated. Counsel for the petitioner was also advised, on November 16, 1942, by James A. Croty, Esq., 332 Main Street, Worcester, Massachusetts, that he had an appeal then pending in the Circuit Court of Appeals for the First Circuit involving the evaluation, for the purpose of the estate tax, of "stock subject to restrictions providing that a stockholder desiring to sell was required to offer the stock first to the corporation which might buy it at book value". That case was tried in the Board of Tax Appeals before the Honorable John M. Sternhagen, the same Member of the Board before whom the instant case was tried.

It is therefore respectfully submitted that the foregoing petition for certiorari should be allowed, to the end that this

Court may clarify the law with respect to the effect to be given to restrictive or option agreements in determining the value of stock subject thereto for tax purposes, thereby putting an end to further litigation involving this problem.

5. The decision of the Circuit Court in the instant case is arbitrary and capricious, in that it is not supported by substantial evidence.

As has been noted, in the instant case, the Circuit Court, in determining the value of the stock here involved, failed to give proper effect, if any, to the fact that the stock was subject to the provisions of a restrictive agreement, which unquestionably had some effect upon the value of the stock. The Circuit Court also completely ignored and disregarded the uncontradicted and unimpeached testimony of the petitioner's expert witnesses as to the value of the stock, when subject, or when not subject to the restrictive agreement. These considerations alone would seem to indicate that the Circuit Court's determination of the value of the stock here involved, was arbitrary and capricious.

However, it is submitted that the opinion of the Circuit Court shows on its face that the Court's determination of the value of the stock here involved was arbitrary and capricious, for the following reason: Although in its opinion, the Court determines the value of the stock to be $43. per share, there is absolutely nothing in the opinion which indicates that that value is proper, rather than $20., $30., $50., or $60. per share. That Court itself characterized such an opinion as arbitrary and capricious. See *Tex-Penn Oil Co.* v. *Commissioner,* 3 Cir., 83 Fed (2d) 518, at 523, where the Court said:

> "The board might have said that the fair market value was $1, $10 or $40 a share and its reasoning would have been equally applicable. The board may not fix an arbitrary and excessive value."

Conclusion.

For the reasons herein set forth, it is respectfully submitted the prayer of the foregoing petition should be granted, and that a writ of certiorari should issue to review the judgment of the Circuit Court of Appeals for the Third Circuit entered in the cause between the above-named parties on September 1, 1942.

J. Warren Brock,
Counsel for Petitioner.

APPENDIX.

Statutes Involved.

Revenue Act of 1932, as Amended.

Section 501.

"(a) For the calendar year 1932 and each calendar year thereafter a tax, computed as provided in section 502, shall be imposed upon the transfer during such calendar year by any individual, resident or nonresident, of property by gift.

"(b) The tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible; but, in the case of a nonresident not a citizen of the United States, shall apply to a transfer only if the property is situated within the United States. The tax shall not apply to a transfer made on or before the date of the enactment of this Act."

* * * * * * *

Section 506.

"If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift."

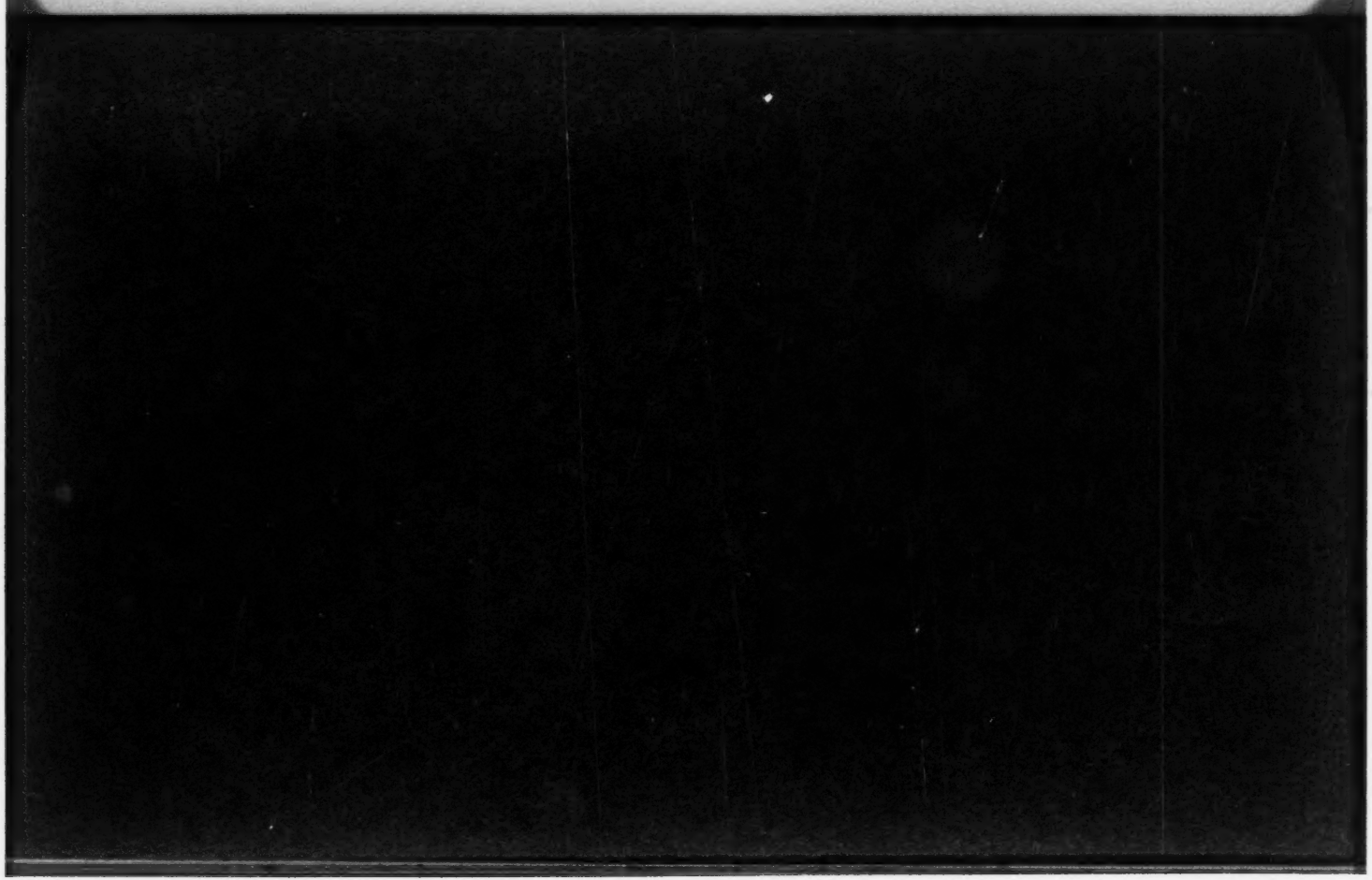
Regulations Involved.

Regulation 79, (1936 Edition).

"Article 17. Gifts made in property.—A gift made in property is subject to the tax in the same manner as a gift of cash, and the amount of the gift is the value of the property at the date of the gift."

* * * * * * *

"Article 19. Valuation of property.—(1) General.—The statute provides that if the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift. The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell."



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502456—42

In the Supreme Court of the United States

OCTOBER TERM, 1942

No. 560

CHARLES T. KLINE, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 193a–199a) is reported at 44 B. T. A. 1052. The opinion of the Circuit Court of Appeals (R. 203–208) is reported at 130 F. 2d 742.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered September 1, 1942 (R. 209). Petition for a writ of certiorari was filed December 1, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, in the circumstances of this case, there was reasonable ground for approving the Commissioner's determination of value of certain restricted stock for gift tax purposes under Section 506 of the Revenue Act of 1932.

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1932, c. 209, 47 Stat. 169:

> SEC. 501. IMPOSITION OF TAX.
>
> (a) For the calendar year 1932 and each calendar year thereafter a tax, computed as provided in section 502, shall be imposed upon the transfer during such calendar year by any individual, resident or nonresident, of property by gift.
>
> * * * * *
>
> SEC. 506. GIFTS MADE IN PROPERTY.
>
> If the gift is made in property, the value thereof at the date of the gift shall be considered the amount of the gift.

Treasury Regulations 79 (1936 Ed.):

> ART. 17. *Gifts made in property.*—A gift made in property is subject to the tax in the same manner as a gift of cash, and the amount of the gift is the value of the property at the date of the gift.
>
> ART. 19. *Valuation of property.*—* * *
>
> * * * * *
>
> (3) *Stocks and bonds.*—* * *
>
> If the value of a security cannot be determined by sales, or from bid and asked prices, as prescribed in the preceding pro-

> visions of this subdivision, then, * * * in the case of shares of stock, upon the basis of the company's net worth, earning power, dividend-paying capacity, and all other relevant factors having a bearing upon the value of the stock. * * *
>
> * * * * * *

STATEMENT

The sole issue in this case involves the valuation, for gift tax purposes, of certain securities transferred in trust by the petitioner on December 24, 1937.

Petitioner, a resident of Merion, Pennsylvania, on December 24, 1937, executed an irrevocable trust, declaring that he had caused to be transferred to his name as trustee 4,500 common shares of E. J. Lavino & Company, "being Voting Trust Certificate No. 11, issued under the terms of a certain Voting Trust Agreement dated January 4, 1930." As trustee, he was to collect the dividends, pay charges incident to management, and pay the net income for his life to his wife, Ellen S. Kline. After his death, interest and principal were to be paid to his wife, son, or the son's descendants. (R. 193a.)

Petitioner became an employee of E. J. Lavino & Company in 1919, and has been a director and executive vice president since 1927. On November 22, 1928, the company distributed 3,000 shares of its common stock, pursuant to directors' resolution authorizing the president and the chairman of the board of directors "to donate and transfer"

certain shares then held in the treasury to "such of the officers or employees of the corporation as they may determine, * * * subject, however, to such conditions, restrictions and agreements as they shall in their discretion impose and make * * *." The conditions and restrictions were embodied in a written instrument which each distributee signed, agreeing not to sell his shares without the company's consent as long as he should remain in its employ, and in the event of death or the severance of his connection with the company, to offer his stock to the company (R. 193a–194a)—

> * * * at a price not to exceed seventy-five percent (75%) of its book value as shown on the Company's statement at the date of the last previous closing of its books for a period of one year from the date of his death or of such severance of connection with the Company, during which period the Company shall have the option to purchase all or any part of such stock, * * *

In the event that the employee should sever his connection with the company "under conditions not acceptable to its Board of Directors or with which the said Board is not in sympathy", he was to offer his stock to the company on the above terms "at a price not to exceed fifty percent. (50%) of its book value", and in the event that he should be discharged for cause, "at a price not to exceed thirty-three and one-third percent. (33⅓%) of its book value." The agreement

was made binding on his executors, administrators, and successors. All share certificates issued to the employees bore this endorsement (R. 194a):

> This certificate and the shares of stock represented thereby are transferable only upon compliance with the covenants and conditions set forth in an agreement in writing between the stockholder and the Company dated November 22, 1928.

Of the 3,000 shares so distributed in 1928, petitioner received 700. On October 22, 1929, the company distributed 10,300 more shares on the same conditions; petitioner received 3,800. After an amendment of its charter the company recalled its old share certificates and issued new ones in place thereof, and on January 4, 1930, petitioner received a certificate for 4,500 new shares of common stock, subject to the same restriction agreement. On the same date, holders of 45,200 of the 50,000 issued common shares executed an agreement with Edward J. and Edwin M. Lavino, as trustees, whereby certificates for the common shares, endorsed in blank, were transferred to the trustees with full voting rights, and the trustees issued to each depositor a "Common Stock Trust Certificate" for the number of shares deposited by him, entitling him to receive that number on termination of the trust at the end of ten years (or earlier in the trustees' discretion), and meanwhile to receive payments equal to the dividends collected by the trustees on that number

of shares. The certificates were transferable, but bound "each successive holder hereof to all the terms and provisions of [the trust] agreement the same as if such holder were a party thereto." The trustees surrendered all deposited certificates to the company and received a single new certificate for 45,200 common shares. Of the deposited shares, 25,500 were not subject to the restriction agreement; the remainder were subject to it. (R. 194a–195a.)

Petitioner deposited his certificate for 4,500 common shares, and received a common stock trust certificate for a like number. He endorsed this in blank and delivered it to the trustees on December 24, 1937, and on the same date they issued to him, as trustee, common stock trust certificate No. 11, of which he declared himself trustee by the trust instrument of the same date, above described. On December 1, 1937, the company's directors (R. 195a)—

> RESOLVED that there would be no objection on the part of the Corporation to the transfer of common stock registered in the name of Charles T. Kline, subject to restriction agreement, to Charles T. Kline, Trustee, for the benefit of Ellen S. Kline, the said stock after transfer to still be subject to the restriction agreement heretofore obtaining.

On December 24, 1937, petitioner was 59 years of age and had a life expectancy of 14.1 years. His services as a director and executive vice presi-

dent of the company were satisfactory to its officers and directors, and he has since continued in those capacities. (R. 195a.)

The company's books showed a surplus of $1,158,794.63 on December 31, 1936, and of $1,753,779.89 on December 31, 1937. On both dates its capital stock account carried a credit of $500,000 on account of the 50,000 shares of common stock; $142,679.86 was carried as a reserve for doubtful accounts. The company is successfully engaged in the business of shipping, importing ores, and manufacturing refractories. Its earnings and dividends for two years prior and two years subsequent were as follows (R. 196a):

Year	Gross Income	Net Income	Preferred dividends paid	Available for common dividends	Dividends per common share	Common dividends paid
1936	$7,318,238.28	$569,151.26	$141,281.25	$427,870.00	$4.00	$200,000.00
1937	8,403,870.99	838,443.92	42,812.50	795,631.42	4.00	200,000.00
1938	6,747,467.71	229,034.80	42,812.50	186,222.30	.75	37,500.00
1939	7,558,900.57	812,231.70	42,812.50	769,419.20	4.00	200,000.00

The Board sustained the Commissioner's valuation of $43 per share (R. 199a). The court below affirmed (R. 209).

ARGUMENT

In view of the expanding business of the company in an established field, a large and sound capitalization, an increasing surplus, and current earnings which were considerably more than necessary to pay dividends of $4 per share, the stock undoubtedly had a very substantial value for gift tax purposes. The voting trust did not of itself

impair that value. Where the purpose was, as here, to insure continuity of management and to prevent internal friction, the usual consequence of such a voting trust is to enhance the value. Thus, the only depressing factor is the restrictive agreement under which the company had the option to repurchase the stock under specified conditions. In analyzing the real effect of such a factor, the Board and the court below properly considered the probability of its use in the light of circumstances as they here appear; and in approving the Commissioner's finding of $43 per share the Board noted that this figure reflected a substantial allowance for the adverse effect of the restriction, since the value would otherwise have been considerably higher. This is a reasonable and a practical solution to a troublesome factual question and the decision presents no ground for the issuance of the writ.

1. The decision below does not conflict with *Helvering* v. *Tex-Penn Co.*, 300 U. S. 481. In the *Tex-Penn* case this Court stated, as an alternative ground for its decision, that profit realized upon a certain exchange was not taxable because the securities received in exchange did not have a fair market value capable of being ascertained with reasonable certainty when viewed in the light of their highly speculative quality and in the light of a restrictive agreement. (P. 499.) It is exceedingly dubious whether the Court would have reached that conclusion upon the basis of the restrictive agreement alone. Indeed, in *Whitney Corporation* v. *Commis-*

sioner, 105 F. 2d 438, 441 (C. C. A. 8th), the court specifically stated that it understood that branch of the *Tex-Penn* decision to rest primarily upon the highly speculative character of the securities. No such facts are present here. See also *Heiner* v. *Gwinner,* 114 F. 2d 723 (C. C. A. 3d), certiorari denied, 311 U. S. 714.

2. Probable conflict with *Helvering* v. *Salvage,* 297 U. S. 106, is also asserted. (Pet. Br. 10.) There the restriction was specific as to time and amount and was between parties who might be expected to press their bargaining advantages. *Propper* v. *Commissioner,* 89 F. 2d 617 (C. C. A. 2d), and *Lomb* v. *Sugden,* 82 F. 2d 166 (C. C. A. 2d), likewise relied upon (Pet. Br. 15–16), are similarly distinguishable. In the case at bar, the Board and the court below both concluded that it was highly improbable that the option in the restriction agreement would ever be exercised and, if so, only at the higher basis. In such a case, it is appropriate to consider the practical effect of the restriction and the probability of its use. *Newman* v. *Commissioner,* 40 F. 2d 225 (C. C. A. 10th), rehearing denied, 41 F. 2d 743, certiorari denied, 282 U. S. 858.

3. The failure to place full reliance upon the opinion testimony of the petitioner's witnesses as to the value of the stock furnishes no ground for certiorari. The cases cited (Pet. Br. 16) turn upon their own facts. See in this connection *Uncasville Mfg. Co.* v. *Commissioner,* 55 F.

2d 893 (C. C. A. 2d), certiorari denied, 286 U. S. 545, in which the court expressly indicated that *Bonwit Teller & Co.* v. *Commissioner,* 53 F. 2d 381 (C. C. A. 2d), did not lay down the general rule here attributed to it by the petitioner. (Br. 17.) In a valuation case where other evidence is submitted, opinion testimony is only one factor to be considered. *Dayton P. & L. Co.* v. *Comm'n.,* 292 U. S. 209, 299; *Rogers* v. *Helvering,* 107 F. 2d 394 (C. C. A. 2d). It seems clear from the respective opinions that both the Board and the court below here reached a correct conclusion based upon a reasonable evaluation of all the pertinent factors.

4. The decision below is not arbitrary and capricious, as the petitioner asserts. (Br. 20.) The case can not be argued as if the most drastic of the eventualities had occurred. Nothing had happened at the time of the gift to invoke any one of the contingent options.[1] If reasonable weight

[1] In the circumstances here presented (R. 198a), it was highly improbable that any option would have been exercised by the company. Perhaps the most likely eventuality was that the petitioner would die or resign under favorable circumstances, thus giving rise to the option of the company to purchase the stock at seventy-five percent of the book value as of the last closing of its books. The taxable transaction took place on December 24, 1937. It was not likely that this eventuality would occur in the few intervening days prior to the closing of the books on December 31, 1937. Hence, to test the Commissioner's determination, it is reasonable to look to the book value as of that date rather than a year back, December 31, 1936, as the petitioner insists. The Board

is given to the improbability of the exercise of the option at either of the two lower levels, at least in the immediate future, and to the permanent and expanding nature of the business, there is ample justification for the determination of $43 per share, giving full consideration to the restriction in the light of the unique circumstances here disclosed. In the two years immediately following the gift, the company's surplus account increased approximately fifty percent (R. 41a). In 1937, the year in which the gift was made, the company earned approximately $16 per share on the outstanding 50,000 shares of common stock (R. 44a, 73a). In the years 1936 through 1939, the company's net income was the approximate equivalent of $49 per share (R. 44a, 73a). Without the restriction, the value might well have been set at a figure far in excess of $43 per share. There is no basis for the petitioner's assertion (Br. 20) that the decision approving a valuation of $43 per share was arbitrary and capricious and that it attached no material weight to the restriction agreement.

---

found that (R. 195a) as of December 31, 1937, the company's books showed a surplus of $1,753,779.89, a capital stock credit of $500,000 on account of the 50,000 shares outstanding, plus a reserve for doubtful accounts of $142,679.86. Seventy-five percent of this aggregate book value would exceed $36 for each of the 50,000 shares. The valuation of $43 per share is thus approximated even if it be assumed that the condition would arise and that the company would exercise the option on the petitioner's death or resignation. When further allowance is made because of the likelihood that even to this extent the option would never be exercised by the company, then the figure of $43 as the true value can not be said to be excessive.

CONCLUSION

The Board correctly applied and the court below approved recognized principles of valuation to the unique facts of this case. There is no conflict. The petition should be denied.

Respectfully submitted.

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SAMUEL O. CLARK, JR.,
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JOSEPH M. JONES,
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DECEMBER 1942.

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